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Monthly Letter

Business and Economic Conditions

New York, January, 1957

General Business Conditions

THE closing weeks of 1956 have brought new all-time peaks in most measures of over-all business activity. The gains over the figures of a year ago, which were the highest on record up to that time, are not large in physical terms, but they are satisfying in view of the readjustment that some important industries have gone through. New highs in dollar measures of economic activity, such as gross national product and national income, are subject to the qualification that 1956 was a year of rising prices and living costs. Inflation of dollar values in itself adds nothing to real living standards and creates only an illusory prosperity. However, gains have also been made in real terms. The figures of recent weeks include new highs in industrial production, employment, and retail sales. Christmas business disappointed many merchants at the start, but final reports show that the season's sales as a whole made satisfactory gains over 1955.

As a result of the record outpouring of goods and services, American consumers are enjoying the highest living standards in history. At the same time business and governmental bodies are adding substantially to national wealth and future productive capacity through capital investment and public works. Increases in personal consumption and in real saving — which is the source of future consumption gains — are the twin objectives of balanced economic growth. By either criterion, the country is prospering. It is also entering 1957 under good momentum. In the aggregate, demands on the economy are as large as can be satisfied, and in some key areas they exceed capacity.

The Year of "Rising Readjustment"

The year just ended was one of contrasts. Most of the comprehensive measures proclaim it a year of new records — $412 billion in goods and services produced, personal income totaling $325 billion, a peak of 67 million employed (nearly 70 million including the armed forces), and factory wages exceeding $2 per hour. Not all business and individuals, however, shared this prosperity in full. Laid-off auto workers, home builders, steel workers called out on strike, and business men whose profits were pinched by rising costs were among those for whom 1956 fell short of hopes.

At this time a year ago, few observers would have believed that business could withstand a drop of one fourth in automobile production, a 15 per cent cut in the number of homes started, and a five-week steel strike without more serious repercussions. Adjustments were also needed or under way in agriculture and in the textile, farm machinery, and other industries.

Yet the combined drag of these important sectors of the economy was more than offset without resorting to easy money or to government stimulus. The strength of consumer demand for nondurable goods and services, the heavy backlog of local government projects, and business investment needs kept the economy steady

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and headed upward. Not only was a general recession avoided, but gross national product — the nation's aggregate output of goods and services — rose quarter by quarter, and at the year's end had reached the record annual rate of about $422 billion, $20 billion or 5 per cent greater than a year earlier. Perhaps, following this demonstration of the economy's ability to absorb substantial shifts in demand without interrupting over-all progress, the expression "rolling readjustment" needs to be laid aside, so far as 1956 is concerned, in favor of "rising readjustment."

The Capital Goods Boom

The key to the resilience of the economy in 1956 was the capital goods boom. It is likewise the key to the 1957 outlook. During the past year and a half, rising costs and stiff competition have stimulated nearly every major industry to increase its capital outlays. Business men have shown increasing awareness of the need for expansion to serve growing markets, for modernization as a means of saving labor and cutting costs, and for long-range planning of plant and equipment needs. In 1956, business outlays on new plant and equipment increased 22 per cent over 1955, and by the fourth quarter they had reached the peak annual rate of $37.3 billion. In manufacturing alone, capital expenditures rose over 30 per cent.

In 1957, according to a recent McGraw-Hill survey, business men expect to spend 11 per cent more on plant and equipment than in 1956. Other surveys, both private and govenment, support this finding. Since the current rate of capital outlays is roughly 8 per cent greater than the average 1956 rate, business can achieve the goals anticipated in the McGraw-Hill survey with only a small increase over the current figure.

It is doubtful that labor and materials could be found for a greater increase in capital spending in 1957. Necessarily business firms must tailor their plans to fit the cloth. During the greater part of 1956 they could not complete new facilities as rapidly as they had planned. Output and construction were bumping against the ceiling of capacity. Shortages of steel plates, structural shapes, and other critical items delayed deliveries by plants with orders well in excess of capacity and difficulties in arranging financing limited what could be done. Doubtless they will continue to do so in 1957.

Thus, a switch from rapid growth to a leveling off of capital outlays seems indicated. This need cause no dismay. A leveling off of the current rate would still produce a record-breaking investment total for 1957 and provide strong support for the economy. The same forces which are trimming the peak off the boom are also prolonging it by deferring demand to a later period. McGraw-Hill, in its survey, found that approximately $2.7 billion of 1956 investment plans had been carried over into 1957 for various reasons, and some 1957 plans already have been put off until 1958. They found little evidence of cancellation or abandonment.

In other words, demand for capital goods has not subsided, but it is being spread out more evenly.

Flattening Out the Boom

Such a flattening out is all to the good. It increases the possibility of a long, flat crest to the capital goods cycle, thus avoiding the dislocations which accompany a rapid contraction of demand. It also relieves some of the pressure on prices, which would otherwise accentuate the boom and bust pattern.

Already price increases have exaggerated the upswing in plant and equipment and added to the demand for investment funds. As much as one third of the 22 per cent increase in capital outlays from 1955 to 1956 represented higher prices. Between the insistent demand and the push of higher labor and material costs, prices of producers' finished goods were about 8 per cent higher in 1956 than in 1955, and construction costs on private nonresidential projects were up roughly 5 per cent. In estimating their 1957 plant and equipment outlays, business men allowed for further price increases averaging 6 per cent — more than half of the over-all increase of 11 per cent which they anticipated.

The advance in prices would have been greater had it not been for the restraint exercised by the monetary authorities. By dampening money and credit expansion, the Federal Reserve Board has been endeavoring to hold the demand for investment goods more closely in line with capacity to produce them, and thereby restrain the bidding up of prices for the available supplies. Claims that the Board has set its face against economic growth and that the economy will be throttled by tight money, however, find no support in the foregoing evidence.

Characteristics of the 1957 Economy

Many of the preceding comments on the capital goods outlook apply equally to the general business outlook. Over-all employment and production are nearly as high as is economically feasible, limiting next year's gains largely to the growth in the labor force, industrial capacity, and productivity. Yet continuance, on the average, of even the present rate of activity during 1957 would make this year the best on record.

The development of a long and generally flat crest at a high level would not be unprecedented. The industrial production index remained virtually level for about two years in 1950-52 and for even longer in the middle twenties. In an economy pressed against the ceiling of capacity, over-all stability can conceal major shifts in demand, such as the shift from consumer goods to defense production in the early fifties and from automobiles to capital goods in 1956. If, contrary to current expectations, demand for plant and equipment should slacken in 1957, the steel, manpower, and long-term investment funds thus made available could be put to good use, though probably with a lag, in homebuilding or in schools, highways, and other public works.

It is also possible that the dollar volume of business may advance appreciably in 1957, despite relative stability in physical output, thus creating an illusion of prosperity through price increases. During 1956, the over-all stability of prices which had prevailed since 1952 was upset as wholesale prices advanced 4 per cent in the course of the year and consumer prices went up 2.8 per cent between February and November. Pressure on prices will continue into 1957. Labor costs are already slated to rise. The U.S. Bureau of Labor Statistics reports that in the current year five million workers will get automatic wage increases — mostly 5 to 11 cents per hour — under contracts signed in 1955 or 1956. In addition, roughly 3.8 million workers will automatically receive raises geared to increases in consumer prices. A cost of living raise of 3 cents per hour for steel workers on January 1 is expected to set the stage for steel price increases which in turn will work their way through the economy.

In other respects, the economy enters 1957 in much better shape than it started 1956. Automobile production and farm income appear to be on the upgrade once again. Automobile dealers and steel users successfully worked down the heavy stocks that they piled up in early 1956. The number of new homes started appears to have stabilized at a lower rate, at least for the present. Backlogs of orders for durable goods, at latest reports, were 17 per cent higher than a year earlier. Retailers emerged from a record-breaking Christmas season with expectation of sizable year-to-year increases in the months ahead. Federal, State, and local government purchases of goods and services in 1957 are expected to be $4 billion to $6 billion higher than in 1956, according to Grover Ensley, executive director of the Joint Economic Committee of Congress. All told, the high level of activity and the atmosphere of confidence in nearly all lines promise to send 1957 off to a running start.

Too Good to Last?

The problems of prosperity — rising prices and wages, tight money, bottlenecks in labor and materials, rising inventories, and debt expansion — also persist into 1957. There are two ways of looking at these problems. One is that they emphasize the inflationary dangers and the need of restraint. The other is that they are the traditional symptoms of advanced stages of business upswings.

Dating from the summer of 1954, the forward movement has now lasted two and a half years — with adjustments in particular lines, to be sure, but without a significant general reaction. By historical precedent, this is a fairly long upswing, but not exceptionally so.

Booms generally contain the seeds of their own destruction. Investments in plant and equipment in specific lines may temporarily increase capacity more rapidly than consumption rises. When this happens in marked degree competition intensifies, markets favoring sellers change to markets favoring buyers, profit margins narrow, and both the incentive and the means to expand capital programs are diminished. Meanwhile debts rise and liquidity declines. Inventory accumulation eventually reaches a peak and no longer adds to total demand. Mistakes and miscalculations are made and maladjustments develop which require a period of digestion and correction.

However, the attitude, "Things are just too good to last," is not an adequate basis for expecting a downturn. The stresses and strains which usually accumulate in a booming economy and eventually demand correction are not particularly severe as the new year opens. Inventories are high but not burdensome when related to unfilled orders and general business levels. Inventory liquidation would accelerate a decline but seems unlikely to trigger one. Speculative excesses and unsound credit practices are restrained by the tight money policy. Excess industrial capacity is a potential source of worry but, with few exceptions, not a present one.

From these various facts and sometimes contradictory interpretations, business observers for the most part draw the conclusion that, while the boom may be reaching an advanced stage, signs of a turning point are not much in evidence. In any case there should be no doubt what the problem is. It is to prolong the period of prosperity by restraint and wise management. The path between inflation and deflation continues

narrow and precarious. Stability is promoted by restraining inflation, by saving, and by spreading out demand.

The postwar record of carrying out adjustments while keeping the economy operating at a high level has been remarkably good, particularly in 1956. The whole community – consumers, business men, union leaders, and government officials – has an important stake in avoiding and preventing excesses, in checking the growth of debt and speculative inventory accumulation, and in relieving the pressures which come from trying to do too much too fast in the areas where bottlenecks exist in labor and materials.

Credit Policy Reviewed

During December the money market experienced the usual pressures associated with the Christmas season, rising currency circulation and increasing credit demands of merchants and manufacturers. The Treasury also came to market to borrow an extra $1 billion, to provide dollars for loan to the United Kingdom through the machinery of the International Monetary Fund and Export-Import Bank. The Federal Reserve Banks, purchasing Treasury bills heavily, added to the supply of funds in the market and relieved banks of needs to increase discounts. Nevertheless, money rates and bond yields continued to edge upwards to new high levels. The following table compares year-end money rates and bond yields for 1952, 1954 and 1956.

Year End Money Rates and Bond Yields

Short-Term Money Rates	1952	1954	1956
Discount rate			
Fed. Res. Bank of N. Y.	1.75%	1.50%	3.00%
91-day Treas. bills, new issue	2.19	1.18	3.26
90-day prime bankers' acceptances	1.75	1.25	3.38
3-6 mos. sales finance co. paper	2.18	1.25	3.38
Bond Yields			
U.S. Governments			
5-year	2.36	2.17	3.69
10-year	2.52	2.46	3.57
20-year	2.79	2.57	3.49
Corporate and Municipal			
Aaa corporate bonds*	2.99	2.91	3.82
Baa corporate bonds*	3.50	3.45	4.46
High grade municipal bonds†	2.42	2.35	3.44

*Moody's Investors Service. †Standard and Poor's Corporation.

Hearings on "Tight Money"

On December 10-11 Congressman Wright Patman, Vice Chairman of the Congressional Joint Economic Committee, held limited hearings on credit policy attended by Chairman Martin of the Federal Reserve Board and other members of the Federal Open Market Committee; Elliott Bell, publisher of *Business Week;* Arthur Levitt, Comptroller of New York State; and Robert R. Young, Chairman of the New York Central Railroad.

In his opening statement Congressman Patman said that "it is good sense, good business, and good government to strive in every reasonable way, within the framework of free enterprise system, to promote stability and high-level employment in our economy", but suggested "the danger that the tight money policy may wreck the economy". To keep interest rates down he advised exploring other "control devices" among which he mentioned increasing taxes, selective credit controls and "some sort of capital rationing device".

Seemingly, Mr. Patman would use higher taxes and control devices to curtail business spending for plant and equipment so that more cheap credit could be supplied to areas where he felt that credit was too tight – for home-building, schools, and small business. The difficulty with this approach is that it would omit stimulus to saving from the side of interest rate offered, substitute bureaucratic judgments for the free market process, and stifle the development of the industrial base for better living standards for a growing population.

Chairman Martin's Testimony

Chairman Martin rejected the idea of government intervention in the allocation of credit and set out as the task of the Federal Reserve System "to determine the volume of credit that needs to be made available in order to keep the economy running in high gear – but without overstrain":

> Too much credit would intensify upward pressures on prices. Too little could needlessly starve some activities. We have to rely on human judgments in this determination. There are bound to be differences in judgment – sincere differences.
>
> We do not undertake – and I do not see how it could be otherwise, short of some form of dictatorship – to say how a given supply of credit shall be allocated.
>
> Experience would seem to demonstrate that allocations of credit determined through the market process are to be preferred to judgments – or guesses – of public authorities, however well-intentioned. . . .
>
> It may be that collective judgments expressed through the market process are not always best, but that process is consistent with our heritage and our institutions under which direct governmental intervention in economic affairs is confined largely to broad, general policies necessary to protect and promote the public interest.

"At any given time", Chairman Martin said, "the economy is capable of producing a volume of goods and services limited by currently available resources, human and material. The difficulty throughout this year has been the attempt to crowd too much into a given time period – demand, in brief, has been pressing strongly against the supply of labor and materials":

Creating more money won't produce more things when the economy is running at peak levels. A choice has to be made — and the public in the end has to make the choice of whether we shall have more of this and less of that.

We can have, in a given period, just so many houses, automobiles, household appliances, schools, manufacturing plants, and a myriad of other things, including ships, planes, submarines, and other essentials of defense. Under present conditions, something has to be given up at least for a time.

Throughout this year the combined demand for funds — for credit — coming from virtually all sectors of the economy has been at an all-time high. It has outrun the available supply.

"Contrary to some impressions", he pointed out, "the Reserve System has not reduced the money supply; in fact the money supply has continued to increase this year though at a lesser rate than in 1955":

Moreover, the turnover — that is, the velocity — of the existing money supply has greatly increased. Although the so-called "tightness" of credit is often attributed to an insufficient supply of money, the fact is that the tightness results from the volume and intensity of demand.

He noted that the price advance that began in 1955, after several years of stability, continued during 1956 as output in a number of key areas pressed against the limits of capacity:

Price increases have been particularly marked in sectors affected by investment expenditures, in machinery and construction lines and, affected in part by them, in metals and metal products.

These are the areas in which the restraint imposed upon current expenditures by monetary policy was, quite possibly, the heaviest. It is in these sectors that such additional demand as would have resulted from easier credit would have been concentrated.

• • •

Just now, the year is coming to a close with demands still out-pacing savings, with personal income at a new high annual rate of over 332 billion dollars in October — 21 billion dollars above the rate a year ago — and international disturbances that could add to further overstraining of our resources.

It is a situation that calls for alertness, as well as prudence and restraint, on the part of Government, business, finance, labor, and agriculture.

Credit for Home-building

One of the areas where availability of credit has acted visibly as a check on activity is home-building. Building financed under government mortgage programs at a fixed 4½ per cent rate has been particularly vulnerable because increased offerings of corporate and municipal bonds, at rising yields, have become more attractive to institutional investors. Effective December 4, before the hearings, the Federal Housing Administrator raised the rate on FHA-insured mortgages to a more competitive 5 per cent. It is for Congress to decide whether to re-energize the Veterans Administration's program of guaranteed mortgages by a corresponding increase.

On December 30 Congressman Patman and Senator Hubert Humphrey of Minnesota revealed that they will sponsor legislation to keep the 4½ per cent rate on veterans' mortgages and create a market by using up to $3 billion in federal investment funds to buy such mortgages. Since these funds now have their money invested in U.S. obligations, this would add to the weight of offerings of Treasury securities in the market, depress their prices further, and injure markets for FHA and conventional mortgages, and school and industrial bonds. The money market has enough to engage its resources without this extra burden. In fact, it is supersaturated with offerings of Treasury securities. The real need is not for more offerings of bonds in the market, but for greater caution in government spending, a larger surplus for retirement of federal debt, and tax reliefs to lessen needs of people to borrow to finance capital projects.

"Hidden Taxes"

In his statement Chairman Martin alluded to the responsibility of the Federal Reserve System as a trusteeship over money. He mentioned a calculation that a rise of only one point in the consumer price index would cost the American public two and a half billion dollars a year. Referring to this, Congressman Patman suggested that a rise of one per cent in interest rates on debts of $700 billion would cost even more — $7 billion a year which he calculated as equivalent to $40 per capita. He described increased interest as "the worst kind of hidden taxes", a diversion of purchasing power "from the purchase of necessary things and the conveniences and comforts, and even luxuries of life".

One could refer in similar terms to the not-so-hidden federal taxes. These run ten times as large, around $70 billion a year or $400 per capita. Levied so largely on income, they burden the very process of earning a living. Interest is an expense that, by a policy of economy and saving, the citizen can turn into a source of income.

The cost of a 1 point rise in the consumer price index has some practical significance. Actually, the index rose 3 points in the first ten months of 1956, creating an annual cost by Chairman Martin's calculation of $7.5 billion. On the other hand, there was no $7 billion increase in interest costs during 1956. The $700 billion debt figure Congressman Patman uses includes such things as open charge accounts which are free of interest. Moreover, a dominant part of interest-bearing debt bears contractual rates, determined at the

time loans were made or bonds were issued. Higher rates apply only to new borrowings and renewals.

There can be little doubt, on the other hand, that interest payments and interest income, though still abnormally depressed by past standards, are rising as a proportion of the national income. The payment of interest is an attribute of the capitalistic system, which thereby rewards people for waiting to consume their incomes. The fact is, as pointed out in this *Letter* last month under the heading of "The Cost of Depreciating Money", that savers in most countries for many years have been getting less than nothing for their trust in the future value of money. The "hidden tax" of price inflation has eaten into the value of their principal faster than compound interest has made it grow. So long as this goes on interest is not in the real sense income at all.

Higher interest charges serve the economic function of discouraging unnecessary borrowings, and it is always to be remembered that creditworthy borrowers as a class are apt to be people of superior means, business talents, and earned incomes. Interest income, on the other hand, serves as the foundation for economic security for people of inferior means, business talents and earned incomes. Increased interest rates lower the costs for the federal social security systems, life insurance, and state and private pension systems. They support higher rates of interest on tens of millions of small savings accounts.

Rates paid on savings, reduced to 1 and 1½ per cent under the old easy money policy, have been working upwards for ten years. To give banks more scope to compete for deposits, the Federal Reserve Board and the Federal Deposit Insurance Corporation effective January 1 have raised the limits on the rates of interest banks are permitted to pay on time and savings deposits.

Financing School Construction

No new light was shed on the question, raised by Congressman Patman on many recent occasions, whether small business is feeling the credit pinch more than big business. On the other hand, difficulties of selling bonds to finance school construction brought forth some specific suggestions from Mr. Arthur Levitt, the Comptroller of New York State.

The cost of borrowing to finance school construction, Mr. Levitt said, "has been rising alarmingly". In 1951-52, he stated, New York school districts paid an average of 2.285 per cent on borrowings. In November — a period of acute weakness in the bond market — the average was up to 4.078 per cent and this return is free of federal income tax.

Here is a problem with many facets. One source of the rise in rate is the rise in school population without a corresponding rise in savings flow. The higher rates should attract a larger market, and indeed have produced a certain amount of switching from stocks to tax exempt bonds. But, basically, we have here just one more illustration of a deficiency of savings to do all the things we want to do with borrowed money.

Another factor is cost inflation. Building costs have been rising at an annual average rate of around 6 per cent over the last ten years. One school-bond specialist in Wall Street, quoted by Paul Heffernan in the *New York Times*, has observed that one school built in 1927 for $875,000 could not be put up today for less than $3,800,000. Debt service, he further noted, was a minor part of school district budgets. Other costs have risen too, and not only as a result of increasing staffs and improving equipment but as a result of "easy money" policies which inflated the currency and raised all prices and costs. Dear money and more saving can help check further increase in cost.

One difficulty is a tendency among voters to identify educational needs with elaborate buildings, and to approve bond issues for all kinds of public projects without much regard for the availability of funds in the money market and of labor and steel in the building industry. The result is higher interest and project costs. In the November 6 election, as the table shows, voters approved an unprecedented $2½ billion of bond issues for States and their subdivisions.

State and Local Bond Issues Approved at General Elections

	Submitted	Approved	Per Cent Approved
1951	$1,142,000,000	$1,097,000,000	96.1%
1952	1,461,000,000	1,242,000,000	85.0
1953	926,000,000	850,000,000	91.8
1954	1,589,000,000	1,397,000,000	87.9
1955	1,523,000,000	556,000,000	36.5
1956	2,681,000,000	2,480,000,000	92.5

Source: *The Daily Bond Buyer*

What To Do?

To get cheaper rates on school financing the paramount need is a greater exercise of discrimination by voters in approving bond issues not only for school but for all public purposes. There is always a limit to what the market can absorb at any given interest rate.

Some have urged the Federal Government to subsidize school construction. Apart from the dangers in federal control of education, this

would only add to the burdens on the federal budget and delay relief from the excesses of federal taxation. The Federal Government already gives one aid to school construction in the constitutional exemption of interest on municipal bonds from federal income taxation.

Mr. Levitt told the subcommittee that he was preparing a brochure explaining the merits of school bonds, as an aid to broadening public interest. In communities that want to borrow to build schools, local citizens can help provide the money, benefit from the tax exempt interest income offered, and lower the borrowing cost.

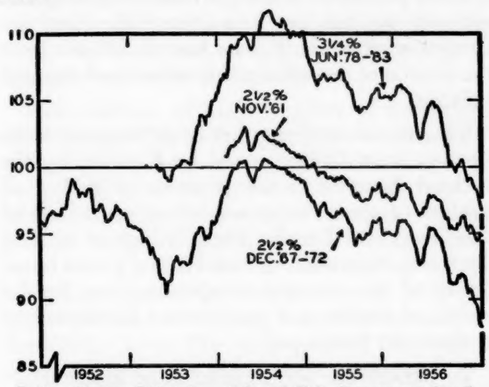
The New York State Comptroller did not endorse federal subsidies for school building but did present three specific recommendations for the Congress: (1) that member banks of the Federal Reserve System be required to hold a certain reserve in municipal obligations; (2) that Federal savings and loan associations be given power to buy them; (3) that the Federal Internal Revenue Code be amended to permit shareholders of investment companies which invest in tax exempt bonds to receive tax free the interest earned on such bonds. The last idea would represent an extension of the "conduit theory" of taxation which, Mr. Levitt noted, would "open an entirely new buyer's market for municipal bonds".

The first of these suggestions calls to mind proposals in the 1947-51 period that banks be required to hold "reserves" of U.S. Treasury obligations. Banks have provided a substantial market for municipal bonds but when their deposits fall off or loan demands increase they lack resources to buy. If municipal bonds had to be held in "reserve" they would cease to be usable to raise cash in case of need. Municipal bonds ought to be salable on their own merit, in competition with other investments. Their exemption from income taxation already gives them a unique competitive advantage.

The second and third of Mr. Levitt's recommendations are worthy of careful consideration. There are also ways that the States themselves can reduce interest costs on school bonds, as by becoming the borrowers and lending to their school districts. Surely there are institutional changes that can help broaden the market, even though in the final analysis there is no escape from the principle that funds sought must be limited to funds available.

U.S. Bonds at a Discount

In questioning Mr. Elliott Bell, Congressman Patman mentioned the drop in British Government bonds below 60 and noted the decline to about 88 in the price of U.S. Treasury 2½ per cent bonds sold in financing World War II. The chart shows the price fluctuations of the Victory Loan 2½s due December 1972 as well as selected postwar issues. How can people, Mr. Patman wondered, "prepare and plan and contract for the future when there is no reliance in the bond market and there is no reliance in the interest rate?"



Friday Closing Bid Prices, Selected U.S. Government Bonds
(Last plotting for Friday, December 28)

Assuredly there is reliance in the interest rate, which does not change over the life of the bond. On Treasury bonds of the type traded in the open market, price fluctuation is the risk of the buyer; the U.S. Treasury is free from any obligation save paying interest and redeeming at maturity. Until 1951 the Federal Reserve Banks undertook to create money to keep the 2½ per cent bonds above par. This was a fine thing for investors who wanted to cash in. But it was a poor thing for the U.S. dollar which not unnaturally lost buying power. To paraphrase Mr. Patman, how can people prepare and plan and contract for the future when the dollar is wasting away in value?

The reason U.S. bonds have been declining in price is that lending institutions are under need to sell and absorb losses in order to meet the pressure of credit demands from industry, homebuilders, States and municipalities. This has created buying opportunities for anybody with savings to invest and beyond doubt is broadening the ownership among the general public of Treasury bonds of the type traded in the open market.

Turning to the attractiveness of Treasury bonds at discount prices, Congressman Patman posed another question:

> How can we with a straight face go out and try to induce people, small savers, to put their money into [Series E Savings] bonds that will yield only three per cent after ten years, when they can go right in the market right

now and buy bonds that will pay them up to much over three and one-half per cent?

The interest rate scale offered under the Savings bond program may at some point need to be raised. But the Savings bond holder may be content to take less than the market offers because he is free from any concern over market price depreciation. In this respect he is in a favored position. He can get back his money and accrued interest on a contractually fixed redemption schedule. But he has no defense from the erosion of the value of his investment through inflation.

Thus the worst thing that could happen to the Savings bond holder would be a return by the Federal Reserve to the practice of giving all holders of government securities, regardless of their contractual terms, the privilege of turning them into cash without loss. He is a prime beneficiary of the restraint on spending felt by the owner of marketable government bonds selling at discounts below par.

To paraphrase Mr. Patman once again: How can we with a straight face go out and try to induce small savers to put their money in any government bonds unless we are willing to exert every effort to protect the dollar?

The lesson out of experience is that cheap money is depreciating money. People will hold a higher respect for money if it is not made too plentiful and easy to borrow.

Aftermath of Suez

The situation in the Middle East and its possible repercussions throughout the world have continued to occupy the minds of people everywhere. Following the first shock and confusion attendant upon the blocking of the Suez Canal and the partial disruption in the flow of vital Middle Eastern oil to Western Europe, a program of positive action to meet the crisis has been developing. European countries faced with oil shortages have moved to conserve stocks by reintroduction of gasoline rationing or by other measures to curb nonessential consumption. Action is being taken to increase alternative oil supplies through a stepping up of Western Hemisphere production and pooling of tanker transportation. Moves have been made to bolster European monetary reserves.

With the slump in the sterling area's holdings of gold and dollars to $1,965,000,000 at the end of November — below the level of $2 billion widely regarded as a safe minimum — the British Chancellor of the Exchequer, Harold Macmillan, announced a series of emergency actions to "maintain the rate of the pound sterling at its present parity" of $2.80.

Both the U.S. and Canadian Governments were asked to waive interest payments on postwar loans due December 15 and amounting to $104 million. In a move to dramatize to the world Britain's determination to maintain the pound and the large resources available for such support, the British Government requested and was granted the right to draw on the International Monetary Fund to the full extent of its $1.3 billion quota, if necessary. In addition, the British were granted an Export-Import Bank line of credit for $500 million, available for 12 months for the purchase of oil and other commodities in this country.

These counter moves and the impressive display of assets have had their effect in damping down early apprehensions, and there has been a disposition to take a calmer view of the situation. With more opportunity for studying the figures, first appraisals of the extent of damage done to the European economy are tending to be revised downward.

Much obviously depends on the length of time the Suez Canal is blocked and the extent to which emergency measures are able to sustain European economies. Some drain upon balances of payments is certain. For countries already experiencing payments difficulties this could be a serious matter, threatening to undermine the basis of Western Europe's remarkable industrial expansion and unprecedented prosperity of recent years.

World on the Eve of the Suez Crisis

The condition of the Free World, before the Suez flareup in July, was quite different from its state when the Korean War erupted in July 1950. It was incomparably more prosperous and stronger economically and financially. In September '56, the gold and dollar assets held by the Free World countries other than the U.S. aggregated $29 billion (excluding holdings by international institutions) as against $19 billion at the end of '50. Balance of payments difficulties recently had not reflected the chronic state of underproduction due to wartime destruction of productive facilities. Rather, they reflected temporary pressures resulting from buoyant internal demand.

Capacity to produce and the actual volume of production had expanded everywhere. The index of world industrial output prepared by the United Nations was some 37 per cent above the 1950 level. There were plentiful supplies of foodstuffs and industrial raw materials, the output of

which had been greatly stimulated by the Korean crisis.

For Western Europe, 1956 was the third year of booming business, with both private consumption and investment in plant and equipment at record levels. Industrial production was almost twice as high as before the Second World War. Steel output in 1956 apparently exceeded 82 million tons, against 51 million tons in '50. Gold and dollar reserves continued to grow — at least up to midsummer.

There were, of course, notable differences among individual countries. Industrial expansion continued strong in Western Germany, Austria, and Norway, with French production — previously lagging — showing a vigorous upturn. In Great Britain the industrial production index had leveled out, largely as a result of restraints applied on internal consumption and investment activity.

This pace of economic development and rising prosperity was not, however, without domestic strains and stresses. Wage increases — often greater than increases in productivity — inflated consumer demand and led to rises in costs and prices. Shortages in raw materials and fuels contributed to industrial bottlenecks, leading to rising imports of steel, coal, petroleum, and other products.

As shown in the accompanying table, imports by European countries in 1956 generally increased more than exports, bringing about some worsening in the trade balance. The notable exceptions were the United Kingdom and Germany.

European Foreign Trade, First Ten Months of 1955 and 1956

(In Millions of Dollars)

Country	Exports 1955	Exports 1956	Imports 1955	Imports 1956	Excess of Exp. + or Imp. — 1955	Excess of Exp. + or Imp. — 1956
Un. Kingdom	$6,972	$7,697	$9,013	$9,164	—2,041	—1,467
Germany	4,926	5,952	4,707	5,405	+ 219	+ 548
France	3,829	3,718	3,786	4,589	+ 43	— 872
Netherlands	2,195	2,373	2,631	3,078	— 436	— 705
Belgium	2,236	2,617	2,308	2,613	— 72	— 4
Italy	1,532	1,758	2,237	2,575	— 705	— 817
Sweden	1,407	1,580	1,623	1,804	— 215	— 224
Switzerland	1,058	1,172	1,212	1,434	— 154	— 262
Denmark	856	909	964	1,068	— 107	— 159
Norway	528	640	914	1,002	— 386	— 362

Mutual Dependence of Europe and Middle East

Against this general background came the shock of the Suez Canal Company nationalization last July, followed three months later by blockage of the Canal and interruption in the flow of Middle East oil.

Twenty or even ten years ago — before Europe became so dependent on Middle East oil for its energy requirements — such events would have been far less serious than today.

In no part of the world has the consumption of oil risen as rapidly during the past ten years as in Western Europe. According to the Organization for European Economic Cooperation's Commission for Energy, the increase was from 37 million tons in 1947 to 100 million tons in '55 — an annual growth of 13 per cent, against 6 per cent for the U.S. This tremendous expansion reflected three main influences: large increases in industrial production and national income, lagging output of coal, and the rapid growth of European oil refining capacity.

The existence of huge supplies of low-priced oil in the Middle East, obtainable for currencies other than dollars, made it the natural source from which Europe could satisfy its oil requirements — thereby increasing European dependence on that area. Of combined Western European and North African consumption of oil amounting prior to the Suez emergency to roughly 3,100,000 barrels a day, two thirds came from the Middle East. The major part of the remainder came from the Western Hemisphere.

This increasing dependence of Western Europe upon the Middle East has of course worked both ways. Revenues derived by the latter countries from the sale of oil to Western Europe have enriched their national treasuries and made possible the promotion of large-scale development programs beneficial to their people. Without the Western market for their oil, these Middle East countries would soon find their vast oil resources sterile assets.

Meeting the Oil Emergency

Turning to the immediate problem of meeting the emergency, the situation that had to be faced was the sudden disruption in the normal flow of the 2,000,000 barrels of oil received daily by Europe from the Middle East.

Although Aramco's trans-Arabian pipeline (Tapline) continued to move 320,000 barrels of oil a day to the Eastern Mediterranean seaboard, the 540,000 barrel daily flow through the Iraq Petroleum Company's pipelines was halted by sabotage. With the Canal blocked, the necessity of moving oil around Africa — some 5,000 miles farther — reduced the carrying capacity of the available tankers by some 600,000 barrels a day.

The problem thus involved finding 1,100,000 barrels a day from other sources, mainly Western Hemisphere, rearranging tanker routings accordingly, and financing the purchases, since Western Hemisphere oil is not only more expensive but must be paid for in dollars.

So far as production is concerned, ample margin for expansion exists. In the U.S. alone the potential increase is estimated as high as 2,000,000 barrels a day – more than sufficient to compensate for the Suez emergency. If Europe's oil deficiency could be made up entirely from the Western Hemisphere, there would be no tanker problem either, since the distance from the Mexican Gulf to Western Europe is actually less than from the Persian Gulf via Suez.

The obstacles to relying wholly upon increased supplies of Western Hemisphere oil are their higher cost and requirement for dollar payment and the disadvantageous location of much of the Western Hemisphere excess producing capacity. In the U.S. pipeline facilities from inland producing areas to Gulf Coast ports are limited. Similar limitations restrict utilization of excess production capacity in Canada and Venezuela.

Under these circumstances the actual program must of necessity be a compromise. U.S. production is expected to be stepped up by about 11 per cent or approximately 800,000 barrels a day. Of this increase, approximately 300,000 would take the place of former U.S. imports of Middle Eastern oil now being diverted, to the lesser extent available, to Europe. The remaining 500,000 barrels per day of the increased U.S. output would be available to Europe, to the extent permitted by pipeline and tanker facilities. The tanker shortage may be partly alleviated by rerouting and release of government tonnage.

What the increased dollar cost of European oil imports will be is hard to estimate. In 1955, as will be noted from the next table, the gross cost of petroleum imports by 15 Western European countries came to the equivalent of $3½ billion, of which Western Hemisphere oil represented around $690 million. The 1957 dollar fuel costs will be substantially increased, both by heavier dependence upon Western Hemisphere oil (and coal as well) and by soaring shipping rates. But these added costs will not involve "billions of dollars", as sometimes stated. Not all of Western Hemisphere purchases have to be settled in dollars, since some of these payments are made in nondollar currencies to British and other foreign owned producers and carriers.

Gross Cost of Petroleum Imports by Western European Countries in 1955

(In Millions of Dollars)

Imports By:	Western Hemisphere	Middle East	Other Areas	Total
United Kingdom	$300	$544	$ 96	$940
France	45	496	31	572
Italy	29	310	11	350
Netherlands	88	159	74	321
West Germany	51	138	54	243
Sweden	73	25	133	231
Belgium	33	97	46	176
Denmark	9	—	88	97
Norway	28	1	55	84
Ireland	9	1	36	46
Greece				45*
Turkey	16	16	10	42
Portugal	5	22	13	40
Finland	3	—	37	40
Austria	1	—	13	14
Total	$690	$1,809	$697	$3,241

Source: United Nations: "Direction of International Trade by Commodities, 1955." *Estimated.

How Much Disruption?

Should this program prove practicable, the net oil deficiency in Western Europe would be held down to about 500,000 barrels a day – a decline in total supply of about 15 per cent. Despite its great increase during recent years, oil consumption in Western Europe in 1955 accounted for only 18 per cent of total energy requirements. On this basis the decline in over-all energy would be only 3 per cent. These calculations of course assume no additional interference in the Middle Eastern oil flow.

Over-all figures, however, are unrealistic to the extent that they do not take account of the widely-varying dependence upon oil of the different European countries. This variation is brought out in the next table, showing both growth of oil consumption over the 1948-55 period and percentage of total energy supplied by oil in '55.

Growth of West European Oil Consumption

	Per Capita Consumption of Oil Products (In Kilograms) 1948	1955	Per Cent Increase	Ratio of Oil Consumpt. to Total Energy (1955)
Greece	96	143	49%	73%
Portugal	65	105	62	47
Sweden	431	1,113	158	44
Ireland	153	326	113	39
Denmark	251	620	147	37
Italy	57	197	246	33
Turkey	18	50	178	30
Switzerland	196	412	110	29
Netherlands	229	408	78	26
Norway	373	711	91	25
France	145	357	146	20
Austria	56	237	323	20
Belgium	167	434	160	16
United Kingdom	251	419	67	13
West Germany	42	194	362	9
Western Europe	133	302	127	18
United States	2,000	2,600	30	44

Source: Oil Committee of the OEEC.

It will be seen that the dependence on oil as a source of energy ranges from 73 per cent for Greece – where local coal is low grade and most of the potential hydroelectric power is still undeveloped – down to 9 per cent for Germany, which has abundant coal resources. In Sweden and Denmark the percentages are 44 and 37 respectively, both countries having shifted to oil as a result of diminishing exportable surpluses of coal in Great Britain and Poland.

It will be noted that the 13 per cent shown for the United Kingdom is one of the lowest on the

list. According to the December issue of *The Banker* (London): "An average cut of 25 per cent in oil supplies could probably be borne for a few months without developing serious or cumulative effects, given a flexible allocation of motor fuel to industry and more flexibility for "C" [small commercial] vehicles, and provided that the needs of the big industries – notably steel and glass – that are heavily dependent on oil fuel could be substantially met."

In other words, given the "flexible allocation [rationing] of motor fuel" mentioned, the extent of slowdown of British industry stemming from fuel or transport shortages may – as *The Banker* concludes – be less than most popular comment has seemed to suggest even if the oil stoppage is protracted. Doubtless the same can be said in varying degree of other Western European countries whose dependence upon oil is still relatively low. Thus far the effects have been mainly in the automobile industry where sales have been slowed down by gasoline rationing and other limitations upon motoring.

The foregoing, however, is unfortunately not the whole story, even for those countries where the impact on current output proves to be relatively moderate. As *The Banker* goes on to point out, the total economic burden fastened upon the economy will still be large:

> The escape from serious dislocation and hardship will have been attained chiefly at the cost of a drain upon stocks, severe further damage to the gold and dollar reserves and to the non-dollar current balance of payments as well. Even if, as has been suggested, the visible (non-oil) account shows no immediate net deterioration, that would still conceal a real strain, because a substantial part of the lost imports will have to be replaced eventually, whereas much of the frustration of exports would represent an irretrievable loss – in the sense that new business must be won to make it good.

> Some of the immediate consequences of this crisis may appear to be disinflationary – the loss of exports has this effect, and so has the payment for imports by recourse to dollar reserves. Other consequences, such as the increased government expenditure overseas, have no immediate domestic effect. But almost every one of them represents a future burden, a future inflationary strain – except only to the extent that the real price is being paid currently, by enforced or voluntary abstentions from domestic consumption that ease the pressure upon stocks, upon imports, and upon the gold reserves and upon other capital outlays.

A Crisis of Confidence

Apprehension over these longer-range influences, including the inflationary impact of higher fuel costs, rather than current imbalances, is what has been responsible for pressure on a number of the Western European exchanges, notably sterling. As the Managing Director of the International Monetary Fund, Dr. Per Jacobsson, pointed out in the statement announcing the recent grant to Great Britain of drawing rights on the Fund, the pressure on the pound was not caused "by weakness in the current account, but reflected a decline in confidence which caused remittances of sterling to be delayed and payments through sterling to be accelerated."

It was to counter these psychological and speculative forces or, as the London *Economist* put it, "to impress the foreigners that the attack on sterling is irrational" that the British authorities took a step intended to put the country's "secondary" reserves "on parade" by obtaining permission to draw up to $1.3 billion against Britain's quota in the Monetary Fund. This was the very situation that the Fund was designed to meet, particularly since, as pointed out by Dr. Jacobsson:

> Britain's situation has been and continues to be essentially sound. . . . The credit squeeze was showing good results, the rise in prices had been checked and exports – including those to the dollar market – had reached record levels. . . . A state of equilibrium had almost been achieved.

Other Western European countries may also, if their reserves should fall too low, approach the Fund to see them through the temporary squeeze on their balances of payments. France, whose international payments were under pressure long before the blocking of the Canal, was granted by the Fund a drawing credit of $262 million last October. This amount is equal to 50 per cent of France's quota in the Fund.

Future European Energy Supplies

Finally, reverting again to longer-range considerations, one thing is clear: Western Europe will strive to minimize its exposure to dangers made painfully apparent by the events of the past six months. Incentive has been given to the construction of supertankers capable of operating economically around the Cape of Good Hope, and to efforts to lessen dependence upon Middle Eastern oil generally by developing production in other parts of the world. Major oil producers in the Middle East are reported already reconsidering their future expansion programs in that area. Fuller utilization of hydroelectric resources in Northern Scandinavia, Austria, and Yugoslavia will be encouraged, and new urgency given to development of nuclear power throughout Europe.

In addition, the idea of a common European market, which was already growing, should be strengthened.

J.S.A.